

## Message Text

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INFO AMEMBASSY LONDON

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SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE (EDRC)  
REVIEW OF THE U.K., JANUARY 29

REF: OECD DOCUMENT EDR(76)3

1. SUMMARY: IN REFDOC CIRCULATED FOR JANUARY 29 EDRC REVIEW OF U.K., SECRETARIAT FORECASTS NO GROWTH OF U.K. GDP IN 1976, WITH REAL CONSUMPTION FALLING BY 1.5 PERCENT, FIXED INVESTMENT BY 4.5 PERCENT, AND WITH GOVERNMENT SPENDING PROVIDING THE MAIN ELEMENT OF SUPPORT FOR ACTIVITY. DESPITE WEAK GROWTH OUTLOOK AND PROJECTED RISE IN UNEMPLOYMENT TO 6.75 PERCENT IN 1976 FROM 4.9 PERCENT IN 1975, SECRETARIAT SEES PROSPECT STILL RAPID ALTHOUGH REDUCED INFLATION RATE (24 PERCENT IN 1975; 15 PERCENT IN 1976) AND LARGE CURRENT ACCOUNT DEFICIT (\$4 BILLION IN 1975 AND IN 1976) AS MAIN POLICY CONSTRAINTS, AND FEELS THAT CURRENT MODERATELY RESTRICTIVE FISCAL AND MONETARY POLICIES SHOULD BE CONTINUED THROUGH-

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OUT THIS YEAR. IN ADDITION, SECRETARIAT STRESSES THAT

U.K. SHOULD MAKE EVERY EFFORT TO LIMIT NOMINAL WAGE INCREASES EVEN MORE THAN WOULD BE IMPLIED BY SIMPLE CONTINUATION OF 6-POUND WAGE LIMIT AFTER ITS EXPIRATION IN AUGUST, 1976. FOR MEDIUM TERM, SECRETARIAT SEES EXPANDING PUBLIC SECTOR AND DECLINE OF BUSINESS INVESTMENT AS CENTRAL PROBLEMS, AND NOTES THAT MORE EFFECTIVE CONTROL OF GOVERNMENT EXPENDITURES IS ESSENTIAL TO DEAL WITH BOTH. REFDOC DESCRIBES U.K.'S "NEW INDUSTRIAL STRATEGY" OF SUPPORTING "Viable" INDUSTRIES, BUT INCLUDES NO JUDGMENT AS TO ITS PROBABLE MEDIUM-TERM EFFECTS ON INVESTMENT AND PRODUCTIVITY. MISSION APPRECIATES THAT EMBASSY LONDON SENDING FINANCIAL ATTACHE (WITH WHOM CONTENTS REFDOC HAVE BEEN DISCUSSED) TO ATTEND REVIEW. ACTION REQUESTED: PARTICULARLY SINCE U.S. IS A REVIEWING COUNTRY, MISSION WOULD APPRECIATE RECEIVING SPECIFIC COMMENTS/QUESTIONS FROM WASHINGTON WHICH COULD BE POSED DURING MEETING. END SUMMARY.

2. SHORT-TERM PROSPECTS; DOMESTIC SITUATION: SECRETARIAT ESTIMATES THAT REAL GDP FELL BY 2 PERCENT IN 1975. DROP IN MAJOR DEMAND COMPONENTS WAS PARTICULARLY STEEP IN FIRST HALF OF YEAR WITH STRONG INVENTORY RUNOFF AT 20 PERCENT (ANNUAL RATE), DECLINE IN BUSINESS FIXED INVESTMENT, AND 4.25 PERCENT (ANNUAL RATE) DECLINE IN INDUSTRIAL PRODUCTION BEING ONLY PARTLY OFFSET BY (A) INCREASE IN GOVERNMENT CONSUMPTION AND INVESTMENT; (B) RELATIVE STABILITY OF PRIVATE CONSUMPTION, AND (C) IMPROVEMENT IN REAL FOREIGN BALANCE. IN SECOND HALF OF 1975, STOCK DECUMULATION CONTINUED BUT AT LOWER RATE, AND EXPENDITURES IN NORTH SEA HELPED CUSHION FALL IN BUSINESS INVESTMENT, BUT PRIVATE CONSUMPTION AND REAL FOREIGN BALANCE BOTH WEAKENED, LEAVING PUBLIC INVESTMENT AND CONSUMPTION AS MAIN SUPPORT OF ECONOMIC ACTIVITY.

3. FOR 1976, SECRETARIAT FORECASTS 1.5 PERCENT FALL IN PRIVATE CONSUMPTION, 4-4.5 PERCENT DROP IN TOTAL FIXED INVESTMENT, CONTINUING DECUMULATION OF STOCKS (BUT AT LOWER RATE), WORSENING OF REAL FOREIGN BALANCE, AND FOR THE YEAR AS A WHOLE NO CHANGE IN GDP FROM 1975 LEVELS. SECRETARIAT PROJECTS UPTURN IN SECOND HALF OF YEAR, WITH LIMITED OFFICIAL USE

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REAL GDP GROWING AT AN ANNUAL RATE OF 2 PERCENT, BUT SINCE ESTIMATED GROWTH OF PRODUCTIVE CAPACITY IS 3 PERCENT, SECRETARIAT EXPECTS EXCESS CAPACITY TO GROW AND UNEMPLOYMENT TO RISE FROM 4.9 PERCENT IN 1975 TO 6.75 PERCENT IN 1976.

4. WAGES AND PRICES: FOR 1975 AS A WHOLE, PRICE INFLATION ACCELERATED WITH RETAIL PRICES RISING 24 PERCENT

COMPARED WITH 16 PERCENT IN 1974. HOWEVER, MUCH OF INCREASE OCCURRED IN FIRST HALF OF YEAR WITH MAJOR CONTRIBUTING FACTORS BEING WAGE INCREASES (30 PERCENT), INCREASES IN INDIRECT TAXES, REDUCTION IN SUBSIDIES, STERLING DEPRECIATION, AND DEVALUATION OF GREEN POUND. INFLATION RATE SLOWED TO 15 PERCENT IN SECOND HALF OF

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YEAR REFLECTING SUCCESSFUL IMPLEMENTATION OF 6-POUND WAGE LIMIT, AND MODERATION OF FOOD AND IMPORT PRICES (DESPITE STERLING DEPRECIATION.) SECOND HALF PRICE INCREASES WERE LARGELY RESULT OF DELAYED PASS-THROUGH OF WAGE INCREASES EARLIER IN YEAR AND DEPRECIATION OF POUND. SECRETARIAT FEELS THAT APPLICATION OF PRICE CONTROLS MADE SMALL CONTRIBUTION TO REDUCING INFLATION RATE, SINCE INCREASED COMPETITION AND DESIRE OF COMPANIES TO RUNDOWN STOCKS BY INCREASING SALES LED TO PRICE INCREASES LOWER THAN PERMITTED UNDER PRICE CODE.

5. SECRETARIAT STRESSES THAT SUCCESS IN ACHIEVING U.K.'S

CENTRAL POLICY GOALS (REDUCING INFLATION AND CURRENT ACCOUNT DEFICIT) DEPENDS CRUCIALLY ON CONTROLLING WAGE INCREASES WHEN 6-POUND LIMIT EXPIRES IN AUGUST, 1976. IN ITS FORECAST FOR 1976, SECRETARIAT ASSUMES THAT 6-POUND LIMIT WILL CONTINUE UNTIL END OF 1976, WHICH IMPLIES A 9-10 PERCENT INCREASE IN WAGES AND, GIVEN MODERATION IN IMPORT PRICES, A 15 PERCENT INCREASE IN PRICES FOR 1976 OVERALL WITH SIGNIFICANT DECELERATION LIMITED OFFICIAL USE

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DURING THE YEAR. SECRETARIAT NOTES, HOWEVER, THAT A 9-10 PERCENT INCREASE IN WAGES IS STILL HIGH RELATIVE TO U.K.'S COMPETITORS (ESPECIALLY IN VIEW OF U.K.'S LOW PRODUCTIVITY GROWTH) AND RECOMMENDS POST-AUGUST PAY POLICY THAT WOULD LOWER NOMINAL WAGE INCOMES EVEN FURTHER. SECRETARIAT COMMENTS THAT EXCESSIVE INCREASE IN NOMINAL WAGE INCOMES WOULD BE SELF-DEFEATING, AS REAL GAINS WOULD BE LARGELY ERASED BY MORE RAPID INFLATION, POSSIBLE TAX INCREASES AND DETERIORATION OF U.K. COMPETITIVE POSITION WHICH WOULD REDUCE EMPLOYMENT. THUS, SECRETARIAT STRESSES IMPORTANCE OF ARRIVING AT GIVEN CHANGES IN REAL WAGE INCOMES AT LOWER, RATHER THAN HIGHER, RATES OF INCREASE IN NOMINAL WAGES AND PRICES.

6. CURRENT ACCOUNT: SECRETARIAT NOTES THAT FAVORABLE VOLUME AND TERMS OF TRADE DEVELOPMENTS WERE EQUALLY RESPONSIBLE FOR SHRINKAGE OF U.K. CURRENT ACCOUNT DEFICIT TO \$4 BILLION IN 1975 FROM DEFICIT OF \$8.8 BILLION REGISTERED IN 1974. INCREASE IN EXPORTS TO EASTERN EUROPEAN AND OPEC COUNTRIES COMBINED WITH STERLING DEPRECIATION HELPED MAINTAIN OVERALL LEVEL OF EXPORTS (WHICH FELL ONLY 2.5 PERCENT DESPITE 5 PERCENT FALL IN MARKET GROWTH) DURING YEAR, WHILE DEPRECIATION AND LOW LEVEL OF DOMESTIC ACTIVITY HELPED RESTRAIN IMPORTS. (SECRETARIAT TAKES NOTE OF COST INSURANCE SCHEME FOR EXPORTS, BUT DOES NOT COMMENT ON ITS EFFECTIVENESS.) CURRENT ACCOUNT IMPROVEMENT WAS REVERSED IN SECOND HALF OF YEAR BY SHARP INCREASE IN IMPORTS RELATED TO NORTH SEA OIL DEVELOPMENT PROGRAM, WHILE VALUE OF OIL PRODUCTION WAS ONLY \$300 MILLION. FOR 1976, SECRETARIAT FORECASTS 1.75 PERCENT INCREASE IN EXPORT VOLUMES, 4.5 PERCENT INCREASE IN IMPORT VOLUMES, SOME IMPROVEMENT IN TERMS OF TRADE AND CURRENT ACCOUNT DEFICIT OF \$4 BILLION.

7. SECRETARIAT NOTES THAT ARRANGEMENTS WITH IMF TO DRAW SDR 1.7 BILLION UNDER OIL FACILITY AND FIRST CREDIT TRANCHE ARE ADEQUATE TO COVER MORE THAN HALF THE 1976 CURRENT ACCOUNT DEFICIT. SECRETARIAT COMMENTS, HOWEVER, THAT ALTHOUGH FINANCING OF DEFICIT NOT YET SEEN TO BE A MAJOR PROBLEM, INTEREST AND PRINCIPAL PAYMENTS COULD

GROW FROM 2.5 PERCENT OF EXPORT RECEIPTS IN 1975 TO  
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5 PERCENT IN 1979, AND THAT INCREASED EXPORT REVENUES  
FROM NORTH SEA OIL WILL NOT SIGNIFICANTLY EASE THE DEBT  
PROBLEM EVEN OVER THE MEDIUM TERM UNLESS DETERIORATION  
IN OTHER CURRENT ACCOUNT COMPONENTS CAN BE PREVENTED.

8. FISCAL AND MONETARY POLICY: FISCAL POLICY WAS  
RESTRICTIVE IN 1975, CONTRIBUTING ONLY 0.25 PERCENT  
(OFFICIAL ESTIMATE) TO GDP IN THAT YEAR, WHILE AT THE  
SAME TIME SELECTIVE MEASURES WERE TAKEN TO HELP MAINTAIN  
LEVEL OF EMPLOYMENT AND BRAKE DECLINE IN INVESTMENT.  
SECRETARIAT DESCRIBES MONETARY POLICY AS SLIGHTLY CON-  
TRACTIONARY IN 1975, WITH M3 AND NARROWLY DEFINED MONEY  
SUPPLY BOTH GROWING AT RATE LESS THAN THAT OF NOMINAL  
GDP, AND FEELS THAT THIS STANCE WAS APPROPRIATE AND  
SHOULD BE CONTINUED IN 1976. IN THIS CONNECTION, SECRE-  
TARIAT STATES THAT LARGE PUBLIC SECTOR BORROWING REQUIRE-  
MENT WILL REQUIRE CAREFUL MANAGEMENT, LEST EXCESSIVE  
MONETIZATION OF DEBT LEAD TO UNWARRENED INCREASE IN  
MONEY SUPPLY, DEPRECIATION OF POUND AND RISING IMPORT  
PRICES.

9. MEDIUM-TERM PROBLEMS: SECRETARIAT ISOLATES RISING  
TREND OF PUBLIC SECTOR BORROWING REQUIREMENTS (10 PER-

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CENT OF GDP IN 1975) AND DECLINING TREND OF BUSINESS INVESTMENT AS KEY PROBLEMS FACING U.K. OVER MEDIUM TERM. SECRETARIAT ANALYSIS INDICATES THAT CAUSES OF INCREASE IN PUBLIC SECTOR ARE LARGELY STRUCTURAL IN NATURE: (1) USE OF CONSTANT PRICE BASIS USED TO CONTROL PUBLIC EXPENDITURE (AND IN SECRETARIAT'S VIEW) INADEQUACY OF THIS METHOD IN PERIODS OF HIGH INFLATION; (2) INSUFFICIENT CONTROL OF LOCAL AUTHORITIES' EXPENDITURE; (3) TENDENCY OF CURRENT TRANSFERS AND CONSUMPTION TO RISE FASTER THAN REVENUES, CONSEQUENT FALL IN CURRENT ACCOUNT SURPLUS AND NECESSITY TO FINANCE PUBLIC INVESTMENT BY BORROWING. IMPLICATION IS THAT U.K.'S MEDIUM TO GOAL OF HOLDING GROWTH OF REAL PUBLIC EXPENDITURE TO 2.75 PERCENT PER ANNUM UP TO 1978 WILL BE DIFFICULT TO ACHIEVE.

10. CLOSELY RELATED TO EXPANSION OF PUBLIC SECTOR IS DECLINE IN INVESTMENT IN MANUFACTURING INDUSTRY SINCE 1969, AFTER GROWING AT AVERAGE RATE OF 5.75 PERCENT IN THE 1960'S. SECRETARIAT STRESSED THAT AVERAGE AGE OF CAPITAL STOCK HAS THUS RISEN, LEADING TO DECLINES IN LIMITED OFFICIAL USE

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PRODUCTIVITY OF BOTH CAPITAL AND OTHER FACTORS OF PRODUCTION AND TO SLOWDCWN IN RATE OF GROWTH OF CAPACITY OUTPUT. THE RECENTLY FORMULATED "NEW INDUSTRIAL STRATEGY" IS DESIGNED TO REVERSE THIS TREND BY MAKING AVAILABLE 2 BILLION POUNDS FOR INCREASED INVESTMENT IN "VIALE" INDUSTRIES. ("VIALE" IS JUDGED PRIMARILY BY EXPORT POTENTIAL, BUT LONGER-TERM EMPLOYMENT CONSIDERATIONS ARE ALSO IMPORTANT.)

11. BASED ON ANALYSIS REFD0C, SECRETARIAT SUGGESTS THAT EDRC AGREE TO FOLLOWING MAIN CONCLUSIONS:

(A) DEMAND-MANAGEMENT IN 1976 WILL NEED TO BE STRICT, BUT THERE MAY BE SCOPE FOR FURTHER SELECTIVE LABOUR MARKET MEASURES TO MAINTAIN AS FAR AS POSSIBLE THE LEVEL OF EMPLOYMENT;

(B) IT IS ESSENTIAL FOR PRIORITY TO BE GIVEN TO  
REDUCING FURTHER THE RATE OF INFLATION AND THE  
CURRENT EXTERNAL DEFICIT IN ORDER TO IMPROVE  
MEDIUM-TERM GROWTH AND EMPLOYMENT PROSPECTS, AND

(C) THE GROWTH OF THE PUBLIC SECTOR'S CLAIMS ON  
REAL RESOURCES SHOULD BE REDUCED SO AS TO LEAVE  
SUFFICIENT ROOM FOR PRIVATE INVESTMENT AND THE  
IMPROVEMENT OF THE BALANCE OF PAYMENTS.

12. COMMENT: (1) ONE U.K. MEDIUM-TERM OBJECTIVE IS TO  
HOLD REAL INCREASE IN GOVERNMENT SPENDING TO 2.75 PER-  
CENT PER ANNUM THROUGH 1978. MISSION PLANS TO EXPLORE  
TWO IMPLICATIONS OF THIS OBJECTIVE WITH U.K. DEL: (A)  
SINCE CAPACITY OUTPUT LIKELY TO GROW AT 3 PERCENT OR LESS  
IN MEDIUM TERM, 2.75 PERCENT REAL GROWTH OF GOVERNMENT  
SPENDING MEANS THAT GOVERNMENT TENDENCY TO SQUEEZE OUT  
PRIVATE INVESTMENT WILL NOT BE SIGNIFICANTLY REDUCED,  
AND COULD INCREASE; (B) IF INFLATION CONTINUES AT  
MODERATELY HIGH RATE, 2.75 PERCENT PER YEAR INCREASE IN  
REAL SPENDING IMPLIES SUBSTANTIAL INCREASE IN NOMINAL  
SPENDING, THUS NECESSITATING INCREASE IN TAXES OR IN  
BUDGETARY DEFICIT - WITH ADVERSE EFFECTS ON DOMESTIC  
CAPITAL MARKETS; (2) MISSION ALSO PLANS TO SEEK LATEST  
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U.K. PROJECTIONS OF NORTH SEA OIL REVENUES AND OF WHEN  
THOSE REVENUES COULD BE EXPECTED TO EXCEED IMPORT  
REQUIREMENTS FOR NORTH SEA DEVELOPMENT. IN THIS CONNEC-  
TION, MISSION PLANS TO ASK IF U.K. WOULD AGREE WITH  
SECRETARIAT ANALYSIS THAT GROWTH OF OIL REVENUES WOULD  
NOT IN ITSELF BE SUFFICIENT TO ALLEVIATE DEBT BURDEN  
OVER MEDIUM TERM.  
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